

CRS Report for Congress

Received through the CRS Web

Weak Dollar, Strong Dollar: Causes and Consequences

Updated July 30, 2004

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Summary

After a long and large appreciation, in early 2002, the dollar peaked and has since then steadily weakened in value relative to other major currencies. A weaker dollar will be good news for exporters and those who compete with imports, while consumers of imports will be correspondingly unhappy. Yet it is important to recognize that a falling dollar is symptomatic of the ebb and flow of international capital in and out of the American economy. Those flows will have important implications for domestic interest rates and activities sensitive to credit conditions, such as housing and business investment.

The exchange rates movement will be strongly influenced by the effect of changes in interest rates on the flow of financial capital between countries. One also needs to consider how the expected movement of future exchange rates influences investors now. Inflation, safe-haven and speculative effects, and the size of the trade balance can also be important.

The central role of relative interest rates in generating international capital flows and exchange rate movements makes it important to understand the forces that move interest rates. This points us toward an understanding of the demand for and supply of loanable funds. The economy's pattern of saving and investment will exert a strong force on interest rates. For the United States, a structural tendency for domestic savings to fall short of domestic investment leads to significantly higher interest rates when economic activity picks up speed. Government policy can also affect interest rates and the exchange rate. Large government budget deficits will tend to push up interest rates and the exchange rate. Budget surpluses have the opposite effect. Tight monetary policy tends to raise interest rates and the exchange rate. A stimulative monetary policy has the opposite effect. Recent U.S. economic history has demonstrated the great importance of these fundamental factors in determining the exchange rates path.

As we contemplate the significance of a weakening dollar, it is important to consider the effect of the outflow of foreign capital that causes that weakening on domestic investment and overall economic welfare. In the 1980s, macroeconomic policy had a substantial effect on the level of interest rates and the path of the dollar. Tight monetary policy and large budget deficits pushed interest rates and the dollar upward through 1985 and a reversal of those policies pushed interest rates and the dollar down over the last half of the decade. In the 1990s a steady rise of the dollar from mid-decade on was primarily the consequence of an investment boom in the United States that kept rates of return high and attracted large inflows of foreign capital. In both of these periods upward pressure on the dollar was intensified by a persistently low U.S. saving rate and relatively weak economic performance abroad. The depreciation of the dollar since 2002 is likely the consequence of slower U.S. growth and a move toward a more diversified portfolio by foreign investors. The dollar's near-term path is problematic, but important forces seem poised to put significant upward pressure on the dollar.

This report will be updated as events warrant.

Contents

Introduction	1
What Determines the Dollar's Exchange Rate	2
Demand, Supply, and the Dollar Exchange Rate	2
The Importance of Trade in Assets	3
Expected Rate of Return and Asset Flows	4
Diversification, Safe-Havens, and Asset Flows	5
Fundamental Factors Determining the Level of Interest Rates	7
Capital Inflows, an Appreciating Dollar, and a Rising Trade Deficit	9
The Ups and Downs of the Dollar: 1980 to 2003	10
The 1980s	10
The 1990s	11
The 2000s	12
Instability and the Prospect of a Dollar Crash	12
Where Will the Dollar Go	13
Economic Policy and the Ups and Downs of the Dollar	15
Conclusion	16

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Introduction

From 1994 to early 2002 the real(inflation adjusted) trade-weighted dollar exchange rate appreciated nearly 30%.¹ Since that peak, the dollar has, more or less, steadily depreciated and in mid- 2004 is about 10% below the 2002 level. This fall has been far from uniform against individual currencies. For example, the dollar has fallen twice as much against the euro as it has against the yen and has not declined at all against the yuan. These differences are largely a reflection of the degree to which these countries have used policy to resist their currencies appreciating relative to the dollar.

The strong dollar in the 1994-2002 period was certainly a benefit to U.S. consumers of imports as the rising exchange rate substantially lowered the price of foreign goods relative to the price of competing domestic products. But the appreciating dollar was a rising impediment to the sales of U.S. exporting and import competing industries as the price of their products increased relative to those of foreign competitors. And as the dollar rose so did the U.S. trade deficit. Therefore, we can expect a weakening dollar to be celebrated by exporters and lamented by domestic consumers. We can also expect sustained dollar depreciation to reverse the steady rise of the U.S. trade deficit.

The dollar is not just moving on its own, but is being propelled by some fundamental economic forces. It is important to understand that movements of the dollar are most often symptomatic of the ebb and flow of international capital in and out of the United States, and that these asset market events can also have strong effects on the U.S. economy. Asset market transactions most often occur at a higher volume and at greater speed than do transactions in goods (i.e., imports and exports). Because of this most economists would argue that it is events in international asset markets that “call the tune the dollar dances to.”

This will mean that the net size of these asset flows will generally dictate the position of a country’s trade balance. A country receiving a net inflow of foreign capital will have an appreciating exchange rate and run a trade deficit. A country generating a net outflow of foreign capital will have a depreciating currency and run a trade surplus. The exchange rate moves to equilibrate the inflow with the outflow of goods and assets. This also tells us that because the ups and downs of the dollar are driven by asset flows in and out of the economy, these dollar movements will be

¹The trade-weighted exchange rate index used is the *price-adjusted broad dollar index* reported monthly by the Board of Governors of the Federal Reserve System.

associated with impacts on domestic credit markets, affecting domestic interest rates and, in turn, interest sensitive spending such as housing, consumer durables, and business investment. Thus, while a rising dollar may be bad news for the tradeable goods sector it is likely good news for interest rate sensitive sectors and vice versa for a falling dollar.

The importance of U.S. international economic transactions to a healthy economy is well recognized by Congress, which in recent years has closely monitored many dimensions of U.S. trade performance. The dollar exchange rate, cross border financial flows, and the trade deficit are known to be important to the functioning of the U.S. economy and for the implementation of sound economic policy. They are therefore issues of congressional concern. This report provides background information on the forces that most likely determine the path of the dollar exchange rate. The report also considers recent events in international markets for goods and assets as well as suggest what implications these forces carry for the state of the U.S. economy and for economic policy.

What Determines the Dollar's Exchange Rate

The exchange value of the dollar is determined by the interplay of the demand for and supply of dollars in global foreign exchange market. Prior to 1973, in the so called "fixed exchange rate" era, the dollar's value was fixed at a rate established by international agreement, and the U.S. government was actively involved in maintaining that fixed rate. The fixed rate exchange rate regime grew increasingly untenable in part because of the growing size and mobility of capital flows between countries. In the early 1970s, the U.S. and many other nations changed by default to a "flexible exchange rate" system that endures today.²

Demand, Supply, and the Dollar Exchange Rate

With flexible exchange rates and wide-spread abandonment of *capital controls* the dollar is largely free to move up or down as market forces dictate. In most circumstances the government plays little or no direct day to day role in determining the dollar's value relative to other currencies. The government can certainly use macroeconomic policy to affect the market forces that determine the exchange rate, but instances where the primary policy goal is the exchange rate are relatively rare. The exchange rate is almost always subordinate to the goal of domestic economic stabilization.³ But the exchange rate will certainly move as a collateral consequence of pursuing other economic goals. On occasion, governments will intervene directly in the foreign exchange market, buying or selling particular currencies to induce

² For a discussion of the collapse of the fixed exchange rate regime, often called the Bretton Woods System, see Barry Eichengreen, *Globalizing Capital*, (Princeton, New Jersey: Princeton University Press, 1996), pp. 93-124. Currently about half of IMF member countries allow their currencies to float.

³ Many would argue that the great virtue of floating over fixed exchange rates is that in that regime the monetary authority, free from the need to use monetary policy to maintain the fixed rate, can make domestic stabilization its primary focus.

some adjustment of the exchange rate, but such interventions are also infrequent and, when used, their impact on the exchange rate is often problematic unless the intervention is supported by changes in macroeconomic policy.

In this framework it is reasonable to infer that any observed weakening or depreciation of the dollar is most likely the result of a reduced demand for dollars in the foreign exchange market, an increased supply of dollars in that market, or some combination of both forces. Similarly, an appreciating, or strong dollar, is the consequence of an increase in the demand for dollars, or a decreased supply of dollars, or both in the foreign exchange markets. And most often these changing market forces are the result of actions by private market participants rather than government policy.

The demand for dollars for use in international exchange is a derived demand, driven by foreigner demand for U.S. goods and assets, which of course are denominated in dollars and can only be purchased with dollars. Therefore, to purchase U.S. goods or assets, a foreign buyer must first exchange their home currency for dollars. Transactions in the foreign exchange market do not involve the transfer of large parcels of paper currency between countries. These exchanges are most often speedily achieved by the shifting of electronic balances between commercial banks or foreign exchange dealers. With the purchase of a U.S. good or asset there has also been an increase in the demand for dollars and an increase in the supply of foreign currency in the foreign exchange market. Other factors unchanged, these actions repeated on a larger scale would tend to increase the exchange value of the dollar relative to foreign currency. That is, the dollar will appreciate, meaning that each dollar can be exchanged for a greater amount of foreign currency, and as a result command a greater volume of foreign goods or assets.

Similarly, when Americans buy foreign goods or assets they initiate a similar process; however, it will have the opposite effect on the dollar's exchange value. Exchanging dollars for a foreign currency represents an increase in the demand for foreign currency and an increase in the supply of dollars on the foreign exchange market. This type of transaction repeated on a larger scale would tend to depreciate the exchange value of the dollar relative to foreign currencies, causing each dollar to exchange for less of the foreign currency, and as a result to command a smaller volume of foreign goods or assets.

The salient point is that the relative strength or weakness of the dollar will depend on the relative strength or weakness of the demand of foreigners for dollar denominated goods and assets in comparison to the strength of U.S. demand for foreign goods or assets.

The Importance of Trade in Assets

Looking more closely at the dynamics of world trade today we see that the volume and speed of international asset transactions far exceeds that of goods

transactions.⁴ As in the foreign exchange market, a very large share of asset transactions can be done electronically and therefore move far more rapidly than do goods, which will most often require a slower physical transfer. This means that at any given point in time it is most likely that the relative demand for assets here and abroad will be the dominant force in the foreign exchange market, transmitting the essential energy that drives movement in the exchange rate for the dollar and other widely traded currencies.

Expected Rate of Return and Asset Flows. What determines the size and direction of cross-border asset flows? We can expect that the demand for assets (e.g., bank accounts, stocks, bonds, and real property) by foreigners will be strongly influenced by the expected rate of return on those assets. The level of nominal interest rates can be used as a fairly reliable first approximation of the rate of return on assets that can be earned in a particular country. Therefore, differences in the level of interest rates between economies are likely to animate and direct international capital flows, as investors seek the highest rate of return. When interest rates in the United States are significantly higher than interest rates abroad, the demand for U.S. assets will, other factors unchanged, strengthen the demand for those assets, increase the demand for the dollars needed to buy U.S. assets, and appreciate the value of the dollar relative to foreign currencies. In contrast, if interest rates in the United States are on average lower than interest rates abroad, the demand for foreign assets will likely strengthen and the demand for U.S. assets will likely weaken. This will cause the demand for foreign currencies needed to purchase foreign assets to strengthen and the demand for the dollar will weaken, leading to a depreciation of the dollar relative to foreign currencies.

Yet differences in nominal interest rates may not be all an investor needs to know to guide her decision. One must also consider that the return actually realized from an investment is paid out over some future period. This means that the realized value of that future payment can be altered by changes in other economic variables. Therefore, investor *expectations* of those future events will influence the investors “expected pay off” and, in turn, the relative attractiveness of an asset. Two economic variables of particular relevance to this decision are the expected change in the exchange rate itself over the term of the investment and the expected rate of inflation.

Expectations about the future path of the exchange rate itself will figure prominently in the investor’s calculation of what she will actually earn from an investment denominated in another currency. Even a high nominal return would not be attractive if one expects the denominating currency to depreciate at a similar or greater rate and erase all economic gain. On the other hand, if the exchange rate is expected to appreciate the realized gain would be greater than what the nominal interest rate alone would indicate and the asset looks more attractive.

The influence of exchange rate expectations can significantly complicate the task of judging how exchange rates will move, as we can only imperfectly assess

⁴For a discussion of the tremendous growth of cross-border asset transactions, see CRS Report RL30514, *Global Capital Market Integration: Implications for U.S. Economic Performance*, by Craig K. Elwell.

what informs those expectations and the strength of their effect. It is also possible for exchange rate expectations to introduce some degree of volatility into the exchange rate system, as “speculation” by some investors on the future path of the exchange rate can push the currency, up or down, as speculative actions feed on each other and generate “herd like” behavior. In these situations exchange rate expectations become a sort of self-fulfilling prophecy that works to exaggerate the path the currency is already set upon, pushing the currency well beyond what more basic fundamentals alone would dictate.

But this is going to be a bounded process. For at some point this speculative motive will also likely work to counter the ongoing trend, as the risk vs. reward calculus causes a growing number of traders to doubt the likelihood of the dollar moving further on its current path and to come to believe that depreciation is the more probable event. As you might expect, such speculative behavior often makes it difficult to accurately predict the magnitude and duration of exchange rate movements, particularly in the short run.

The impact of *expected inflation* on investor decisions is more indirect. To a foreign investor, the U.S. rate of inflation would have little direct effect on his expected rate of return from a dollar denominated asset. The critical uncertainty for him is the path of the exchange rate, which will determine how any given dollar return will translate into his own currency. However, relative inflation rates among nations can be a predictor of where and how much the exchange rate will move in the future and, therefore, potentially relevant to the foreign investor’s assessment of his expected return. If the United States has a lower inflation rate than that of a trading partner, the dollar can be expected to appreciate relative to that currency by an amount necessary to maintain parity in real purchasing power. If the United States has the higher rate of inflation, then the dollar would tend to depreciate so as to maintain real purchasing power. In other words inflation differences will change the nominal exchange rate but not the real exchange rate.

Another reason inflation may influence the demand for assets is that trends in the level of prices can be a telling indicator of how well or poorly an economy is managed and whether the investment climate will change for better or worse. Economies with accelerating inflation are more likely to be ones that are poorly managed, with poor investment prospects; while economies with stable or decelerating inflation may be seen as better managed and likely a more attractive destination for investment. The aggressive and successful U.S. dis-inflation policy in the early 1980s may have contributed to the dollar’s sharp appreciation in this period. In recent years inflation in the United States has been consistently low and the current posture of the Fed gives us no reason to believe that this pattern will change, making this factor of diminished importance for judging recent and prospective movements of the dollar exchange rate. Changes in inflation trends in other countries will still be a factor, however.

Diversification, Safe-Havens, and Asset Flows. While relative levels of interest rates between countries and expected return are likely to be a strong and prevalent force directing capital flows among economies, other factors will also influence these flows at certain times. For instance, the size of the stock of assets in a particular currency in investor portfolios can cause a change in investor preferences.

We know that prudent investment practice counsels that one's portfolio should have an appropriate degree of *diversification*, across asset types, including the currency in which they are denominated. Diversification spreads risk across a wider spectrum of assets and reduces over exposure to any one asset. Therefore, even though dollar assets may still offer a high relative return, if the accumulation has been large, at some point foreign investors, considering both risk and reward, will decide that their portfolio's share of dollar denominated assets is large enough. To improve the diversity of their portfolios, investors will slow or halt their purchase of such assets. Given that well over \$8 trillion in U.S. assets are now in foreign investor portfolios, diversification may be an increasingly important factor governing the behavior of international investors towards dollar assets.

There is also likely to be a significant *safe-haven* effect behind some capital flows. This is really just another manifestation of the balancing of risk and reward by foreign investors. Some investors may be willing to give up a significant amount of return if an economy offers them a particularly low risk repository for their funds. In recent decades the United States, with a long history of stable government, steady economic growth, and large and efficient financial markets can be expected to draw foreign capital for this reason. The size of this effect is not easy to determine, but the disproportionate share of essentially no risk U.S. Treasury securities in foreign holdings suggests the magnitude of safe-haven motivated flows is probably substantial and must exert a bias towards capital inflows and upward pressure on the dollar.

Given the importance of expectations in decision making and the speed with which many asset transactions can occur, exchange rates can be volatile and predicting the magnitude and duration of short-run exchange rate movement with precision is a very elusive goal. But broad, long-term trends can most often be explained by assessing the fundamental macroeconomic forces that affect the relative level of interest rates and the expected rate of return between the U.S. and the other major economies.⁵

⁵The issue of exchange rate volatility has been the focus of much discussion among economists. Contrary to expectation, exchange rates have been much more volatile since the demise of the Bretton Woods system. There are two principal explanations. There is an inherent tendency for "overshooting" of equilibrium in these markets or exchange markets are subject to large scale "destabilizing speculation." For the creators of the Bretton Woods system the deleterious effects of destabilizing speculation were thought to be substantial and an important reason for *not* allowing exchange rates to float. In recent years, the locus of opinion has shifted more toward the destabilizing speculation explanation as evidence of investor irrationality has accumulated. The effect of volatility on the prices and volumes of goods in world trade seems to have been small, however. The enhanced ability to hedge exchange rate risk in modern markets may explain this small effect. We can expect that economies with large trade sectors, such as those in Europe, will find volatile exchange rates more disruptive than will economies with relatively small trade sectors, such as the United States. Yet, whatever costs exchange rate volatility does cause must be balanced against the considerable benefits of liberalized international capital flows.

Fundamental Factors Determining the Level of Interest Rates

Changes in the level of interest rates are usually central to understanding movement of the dollar's exchange rate. So what factors are likely to move interest rates up or down? Again, the level of interest rates is largely a market driven phenomenon governed by the demand for and supply of loanable funds.

The Demand for Loanable Funds. On the demand side of the loanable funds market we look for changes in the forces that commonly influence the use of credit. A strong, briskly growing economy with rapidly expanding investment expenditure can be expected to have a rising demand for loanable funds and exert upward pressure on interest rates. In contrast, economic weakness and attenuated investment opportunities would tend to exert downward pressure on interest rates. In addition to the vigor of the private economy, the demand for loanable funds and the level of interest rates can be influenced by the balance of the government budget. Government budget deficits mean that the public sector must borrow to fully fund its expenditures. Such borrowing is a demand for loanable funds and can certainly influence the level of interest rates in the market. Any movement toward larger budget deficits tends to exert upward pressure on interest rates and movement toward smaller deficits would have the opposite effect. Of course, these outcomes will be tempered by the economy's position in the business cycle. In or just after a recession when the demand for loanable funds is weak, these elevating effects on interest rates would be nil, but would become increasingly manifest as an economic expansion matures.

The Supply of Loanable Funds. Of primary importance on the supply side of the market for loanable funds is the nation's rate of saving. That flow represents the portion of current income that the economy has diverted from spending on current consumption and provides a supply of loanable funds, available to finance current investment expenditures. For any given level of demand for loanable funds, we can expect that a higher rate of saving would likely lead to a lower level of interest rates than would a lower rate of saving. Domestic saving can be augmented by an inflow of foreign saving. That is precisely what the capital inflows we have already talked about are. But that inflow will be primarily a response to pressures and incentives initially generated by the relative size of domestic saving and investment. And, of course that response will move the exchange rate.

One of the more significant macroeconomic characteristics of the U.S. economy to emerge over the last 25 years is the economy's low and declining domestic saving rate. That rate has fallen from about 20% of GDP in the 1970s to near 15% today.⁶ A persistently low saving rate creates a significant structural bias towards relatively high interest rates during periods when economic activity and, in turn, the demand for loanable funds is on the rise. As we might expect, in these periods the dollar

⁶ See CRS Report RL30873, *Saving in the United States: How it Has Changed and Why it is Important?*, by Brian Cashell and Gail Makinen.

exchange rate will likely rise, as an increased flow of foreign capital is attracted by those relatively high interest rates.

Government can also influence interest rates from the supply side of the loanable funds market. On the fiscal policy side, whereas budget deficits are an absorber of saving, budget surpluses are government saving that augments the economy's supply of loanable funds. Therefore, any move toward larger budget surpluses (or smaller deficits) will exert downward pressure on interest rates, while smaller surpluses (or larger deficits) tend to increase interest rates. Monetary policy can influence the level of interest rates through its governing of the financial intermediation activities of the banking system. A large share of the nation's saving is channeled to borrowers by banks. By altering the reserve position of banks, the monetary authority can alter the level of loanable funds they will have available for extending credit and thereby the level of short-term interest rates. A restrictive monetary policy tends to raise interest rates, while an expansionary monetary policy tends to lower interest rates. We will also find that monetary policy, less encumbered by administrative and political constraints, is in practice a more flexible tool than is fiscal policy and will be used more often to implement macroeconomic policy, particularly in the short run.

Government Currency Intervention. Government can try to influence exchange rates more directly. Economic theory suggests that if international assets are not seen by market participants as perfect substitutes and risk premiums vary between assets, it is possible for the central bank to affect the exchange rate by altering the asset composition of its and investor portfolios through the buying or selling of foreign exchange. When this action is executed in a way that does not induce a change in the money supply it is called "sterilized intervention." Such intervention has been used periodically by the United States and most other industrial economies to attempt to stabilize or change the value of the exchange rate. Over the years there has been a controversy over whether sterilized intervention by itself is effective at inducing permanent changes in the exchange rate. The evidence, though not unanimous, tells us that such intervention can be effective some times and to some degree, but it remains far from a highly reliable tool.

It is most likely to work when it is used visibly, infrequently, in coordination with complementary intervention by other nations, and when it is aimed at moving the exchange rate in the direction that macroeconomic policy will be pushing the exchange rate. As such, sterilized intervention is unlikely to be effective at moving the exchange rate counter to where enduring market fundamentals would take it. In other words, it is unlikely that intervention could have prevented the strong appreciation of the dollar between 1994 and 2001. Similarly, in the current period intervention is unlikely to be able to weaken the dollar if macroeconomic policy and investor demand begin to push the dollar up.

Capital Inflows, an Appreciating Dollar, and a Rising Trade Deficit

One should also be mindful that as cross border asset flows move the exchange rate, it has an impact on trade in goods. An appreciating dollar makes U.S. exports more expensive to foreign buyers and imports less expensive to domestic buyers. With net inflows of foreign capital and a rising exchange rate the trade balance will move toward deficit as export sales weaken and import sales strengthen. The size of the deficit in goods trade will generally be equal to the size of the net inflow of foreign capital, with the dollar's exchange rate working as the equilibration mechanism.

This sequence makes sense if you consider that a net inflow of foreign capital to the United States represents a net transfer of purchasing power from foreign economies to the United States. However, that purchasing power is denominated in a foreign currency and can be used only to purchase foreign goods. Of course, this process works in the opposite direction for countries that have a net capital outflow. They will experience a depreciating currency and a surplus in goods trade commensurate with the size of the capital inflow. A net capital inflow means a country has sold more assets to foreigners than it has purchased from foreigners or is running a surplus in its asset account. By the same reasoning, a net capital outflow will represent a deficit in its asset account. Thus, across both goods and assets transactions trade is always balanced, a surplus in asset trade must balance a deficit in goods trade, and vice versa.

As we might expect, those whose economic activities are sensitive to credit market conditions and the level of interest rates will find the forces causing the appreciating dollar to be favorable to their economic well-being. Similarly, those who export or who must compete with imports will find these circumstances unfavorable to their economic well being. It is often argued that the trade deficits that accompany a strong dollar also tend to increase the prospect of the nation implementing protectionist policies. Such policies do not change the forces causing the net inflow of capital and, therefore, will not change the trade deficit, but ultimately will impose costs on the economy that exceed any benefits gained.

As with most economic events, there are benefits gained from capital inflows, but at some cost. The strong dollar and its attendant capital inflows was a valuable support to domestic investment activity in the 1990s. Higher investment will boost economic growth and improve economic well being. Without the capital inflow, U.S. investment would have been lower and the future benefits to our living standard reduced. Some of those benefits flow to foreigners who own U.S. assets, but the economy is better off than it would be without the capital inflow. The salient point is that the strength or weakness of the dollar is not necessarily a positive or a negative event, but rather a manifestation of an underlying economic process that helps some, hurts others, but on balance may often bring a net benefit to the overall economy.⁷

⁷For a fuller discussion of trade deficits, see CRS Report RL31032, *The U.S. Trade Deficit*: (continued...)

The Ups and Downs of the Dollar: 1980 to 2003

It is revealing to examine the general path of the dollar since the 1980s in the framework outlined above. In both the 1980s and the 1990s, the dollar soared to record highs but for different reasons. It will also be revealing to see what caused the dollar to fall.⁸

The 1980s

During the 1980s, the dollar exchange rate followed a path of sustained and substantial appreciation followed by sustained and substantial depreciation. The dollar actually began its ascent in 1979 in response to a sharp tightening of monetary policy, which pushed up domestic interest rates. The Fed's goal at this time was not dollar appreciation, but to rein in the double digit inflation afflicting the economy. Nevertheless, as the markets came to appreciate the Fed's resolution in fighting inflation and the likely dual prospect of steadily rising interest rates and decelerating inflation, the U.S. became an attractive destination for foreign investment. The long recession from 1981 to 1983 did not do much to abate the dollar's rise. But the new Reagan Administration's fiscal policy would give a sharp upward push to the dollar as the economic recovery commenced in 1983. Sizable tax cuts along with large increases in defense spending generated large federal budget deficits. That federal borrowing increased the demand for a shrinking pool of domestic saving and added to the upward push on interest rates. Capital inflows increased and the dollar climbed higher. It is also likely that once the dollar's rise appeared relatively steady, a strong round of speculative buying of dollar assets exacerbated the appreciation of the exchange rate. The dollar peaked in 1985, about 50% above its level in 1979.

The next half of the decade would see depreciation of the dollar that was nearly as large. What caused the change? One factor, difficult to isolate precisely, was a turn in the speculative belief that the dollar would continue to rise. At this point, a sufficient number of investors came to believe that the dollar was far above a sustainable level and was now more likely to depreciate than appreciate. Of far more importance to the process of depreciation, however, was a change in economic policy. Investor expectations were given reinforcement by sizable currency interventions by the U.S. and other major economies aimed at weakening the dollar. Whatever the actual effectiveness at changing the exchange rate, these interventions could be taken by international investors as a strong signal as to where the government wanted the dollar to go and that more fundamental changes in macroeconomic policy would support that desire. The Fed moved toward a more stimulative monetary policy that pushed interest rates down. Fiscal policy also slowly began to change toward a lower interest rate track, cutting the size of budget deficits over the last half of the decade.

⁷(...continued)

Causes, Consequences, Cures, by Craig K. Elwell.

⁸The discussion in this section follows that found in Paul Krugman and Maurice Obstfeld, *International Economics: Theory and Policy* (New York, NY: Harper-Collins, 1994), pp. 577-586.

The depreciation of the dollar during 1986, 1987, and 1988 was precipitous, falling to about 40% of its peak value in 1985 and below its 1979 level. In fact, the concern among policy makers here and abroad was that the dollar would fall too far and needed to be stabilized. Particularly, in 1986 and 1987 the United States and other governments made active use of intervention policies in an attempt to halt the dollar's slide. How effective these policies were is unclear, but for this or other reasons the dollar did enter a period of relative stability. This was interrupted in late 1987, when the Fed moved aggressively to counter the depressing effects of that year's stock market crash. Reserves were pumped into the financial system and interest rates fell and with them so did the dollar in 1988. For the remainder of the decade the dollar would not experience any sharp movements, remaining relatively weak.

On balance, the decade showed us that strong dollar trends were not haphazard, but were broadly predictable responses to changes in economic fundamentals that influence the expected rate of return on dollar denominated assets. Moreover, in this period those changes were largely induced by changes in macroeconomic policy. However, the structural fact of the low U.S. saving rate clearly influenced the economic events in this period.

The 1990s

The 1990s began in economic weakness. The pace of economic growth decelerated sharply in 1990 and the economy fell into recession in 1991. In response to the weakening economy, monetary policy turned to a more stimulative stance and the federal budget deficit grew as economic weakness automatically increased government spending and dampened tax receipts. Interest rates in the United States fell. In contrast, economic activity abroad was moving relatively briskly. In this environment, the demand for dollar assets ebbed and the dollar exchange rate fell, depreciating about 15% between 1989 and 1992. In 1992 an economic recovery got underway in the United States, but abroad economic conditions weakened substantially. This change in relative economic performance was enough to induce a moderate appreciation of the dollar, but it remained well below the values of the 1980s.

By mid-decade, however, the pace of economic growth in the U.S. accelerated greatly. What lay behind this change to faster growth was a sharp increase in the pace of investment spending by business and a marked acceleration in productivity growth. The confluence of strong consumer demand, deregulation, trade liberalization, and a rush to more fully integrate computers and information technology into the production process propelled investment spending up at a record pace. Expenditures on new plant and equipment went from about 13% of GDP in 1993 to average over 20% of GDP for the remainder of the decade. But even with the move of the federal budget towards surplus, the flow of domestic saving could not keep pace with investment and interest rates edged up. Couple this burgeoning saving - investment gap with a falling rate of inflation, and juxtapose the exuberant economic conditions in the U.S. with very weak economies abroad, and the United States became a very attractive destination for foreign investors. A quickly rising foreign demand for dollar denominated assets would push the dollar steadily higher,

rising over 30% from 1995 through 2001. With the strongly appreciating dollar, the trade deficit increased to a record high.

This time the dollar's sharp ascent was driven by the private sector. Economic policy moved in conflicting directions, probably making its net impact on the dollar a minor one. The government's move toward budget surpluses certainly added to national saving and likely muted the dollar's rise, but this was unlikely the immediate goal of this policy change. In contrast, the Fed implemented a steadily more restrictive monetary policy that increased interest rates and this may have added to the dollar's upward momentum. Again, the Fed's primary goal was to slow a very fast moving economy and head off any re-acceleration of inflation. A rising dollar's pushing down of import prices was supportive of this anti-inflation goal and made the Fed's task easier, but the Fed was not the principal force behind that appreciation.

The 2000s

A rising dollar and the large inflow of net borrowing that pushes the currency higher may not be inevitably sustainable. Borrower and lender alike may find good reasons to reduce the size of the capital inflow. For the lender, rising risk and the imperative of adequate portfolio diversification can prompt a diminished willingness to acquire dollar denominated assets. For the borrower, a rising burden of debt service (current and prospective) may curb the desire to borrow. And, of course, if the capital inflow is not checked by changes in private market decisions, it can be changed by macroeconomic policy.

The depreciation of the dollar since 2002 reflects a weakening of the demand for dollar denominated assets on the part of foreign investors. Recession in the United States in 2001, a falling stock market, uncertainty about corporate accounting practices, and a steady fall of most interest rates to levels not seen in over 30 years (and falling significantly more than foreign interest rates) all point to a likely deterioration of the attractiveness of the investment climate in this country. Add to this the inevitable elevation of uncertainty due to the ongoing war on terrorism and the war with Iraq, and some depreciation of the dollar is not surprising. It is also very important to consider that given the magnitude of dollar assets that have accumulated abroad, foreign investors may be ready to seek a greater degree of diversity in their portfolios and evidence some movement away from dollar assets.

Instability and the Prospect of a Dollar Crash

When the dollar begins to fall, particularly after a sharp appreciation, concerns are raised about whether a process of depreciation could soon devolve into an outright crash, wreaking devastation on the wider economy. The critical issue is not the dollar per se but the underlying macroeconomic forces that are propelling it. Again the critical force in this regard is the flow of international capital into and out of the U.S. economy. If foreign investors, for whatever reason, try to sharply reduce their holdings of U.S. assets, the dollar will fall. The fear in some minds is that if investors try to flee from dollar assets on a large scale the price of these assets will be bid down and increase the effective interest rates. If the move out of dollars becomes a stampede, the increase in interest rates might be very large — perhaps

large enough to dampen domestic spending sufficiently to stall the already slow moving economic recovery.

Such a disorderly adjustment is possible, but not highly probable. For one thing, the tendency for interest rates to rise in this circumstance works to brake the process, as higher yields assuage uneasy investors. But there is no guarantee that interest rates still wouldn't rise to a dangerously disruptive level. There are, however, other reasons why a dollar crash is unlikely.

Of overriding importance is that, while not booming like the 1990s, the U.S. economy remains fundamentally sound and an attractive place in which to invest. While it is certainly possible that prudent foreign investors might slow their rate of accumulation of U.S. assets, a "stampede" out of the U.S. capital market seems remote. Reinforcing this conclusion, as noted above, is the circumstance that there would seem to be a paucity of better investment alternatives around the globe. Most other major economies have lower growth projections than does the United States. Further, the prospect of a long series of large U.S. budget deficits in a growing economy suggests that interest rates in the U.S. will soon be rising, and will make the United States all the more an attractive destination for foreign capital. Finally, about 75% of foreign investment in the United States is long-term investment (e.g., direct investment in plant and equipment, long maturity bonds, and stocks) which tends to be far more stable than short-term investment flows because it is based on long-run return and is therefore less sensitive to adverse short-run changes in economic conditions.

Where Will the Dollar Go

Predicting the path of the dollar is always a problematic endeavor. Speculative forces can exert strong near-term effects that may not be tied to more predictable underlying fundamentals. But, even looking at fundamentals, the current period seems particularly difficult to gauge because the dollar's path will very likely depend on the resolution of two strong but opposing forces: return and diversification.

The rate of return is a powerful incentive to the investor and there are several reasons why the United States may remain for some time an attractive high return destination. First, the U.S. economy is now in the midst of an economic expansion with a credible prospect of achieving sustained annual growth in the 2.5% to 3.0% range for the next few years. With this growth will come a steady rise in the rate of investment spending. While it may be well short of the pace of the late 1990s, increased investment spending will likely exert upward pressure on interest rates. Second, this recovery is happening in an economy that will still have a very low private sector saving rate, and thereby continue to have a heightened tendency towards higher interest rates during periods of economic expansion. Third, the Federal budget is now in deficit and those deficits are widely forecast to grow larger in the period just ahead. Large and growing federal demands for loanable funds can also be expected to exert significant upward pressure on interest rates. Fourth, for the next year or more economic performance in most other major economies is very likely to be weaker than in the United States, leading to a more pronounced advantage in relative return for the United States. Further, if Europe and Japan are trying to restart their slow moving economies, rising export sales are likely to figure

importantly in their plans. A weakening dollar would mean foreign currencies are appreciating, and dampening their exports. It is very likely these countries will take steps to stop that appreciation, lowering their interest rates. Such steps would work to strengthen the dollar. Taken together these factors will put substantial upward pressure on the dollar.

Nevertheless, at some point the need for adequate diversification of assets in the foreign investor's portfolio will also be a strong motivating force and one that will exert downward pressure on the dollar. Foreign holdings of U.S. assets are certainly large. They are now rapidly approaching a value of \$10 trillion, up over 60% in the last five years. Of course, this would have to be compared to the overall size of world-wide foreign investment holdings to venture a judgement as to whether the foreign portfolio is saturated with dollar assets.

Our knowledge of foreign investor portfolios is limited, but a recent survey by *The Economist* magazine shows that American assets make up 53% of the typical foreign investors equity portfolio and 44% of the typical bond portfolio. As recently as the mid-1990s, these percentages were only about 30%. It has also been estimated that the average investor in recent years has allocated about 80% of his increased wealth to dollar assets.⁹ If you also consider that historically, investors have shown a marked preference for home assets, rarely letting the foreign share rise above 30%, then one might reasonably project that the current holdings of U.S. assets might be very close to the saturation point. Those portfolios have likely seen a reduction of diversification over the last decade, and at some point, foreign investors can be expected to move to increase diversification and become less willing to accumulate U.S. assets at the current pace. But it is not clear that the saturation point has been reached, particularly given the paucity of significantly superior substitutes. Nevertheless, this factor could put substantial downward pressure on the dollar.

Of course, it is not just a matter of what foreign private investors do. The policies of foreign governments for the buying and selling of U.S. and foreign assets can also influence the dollar's path, and path preferred by government policy makers could be contrary to the one dictated by private investor behavior. In the current situation economic policy makers abroad may be uncomfortable with a greatly weaker dollar because of its dampening effect on their exporting industries at a time when they are struggling to maintain the pace of economic activity due to weak domestic demand. As was noted at the beginning of this report, the dollar has fallen far more against the euro than against the yen. This has occurred because the Japanese government, hoping to prevent a major slowing of exports to the United States, has been actively trying to slow the fall of the dollar relative to the yen by purchasing dollar assets. If private investors are moving away from dollar assets on a sizable scale, however, the asset market transactions of one or many governments are unlikely to keep the dollar from falling, but they could certainly effect the timing of that depreciation and its distribution across individual currencies.¹⁰

⁹*The Economist*, Sept. 18, 2003

¹⁰We are not talking here about macroeconomic policy, just government asset market actions
(continued...)

The interplay of the two contending forces of return and diversification may well push the dollar lower, stabilize it, or even push it higher. A common projection is for the dollar to depreciate slowly, by enough to slow the rate of debt accumulation to a slower and more sustainable pace, but not enough to stop the accumulation of debt or lead to any near-term reduction of the trade deficit¹¹

Economic Policy and the Ups and Downs of the Dollar

We know that the macroeconomic tools of monetary and fiscal policy have the potential to strongly influence the value of the dollar exchange rate. In practice, however, these strong policy instruments only rarely take the dollar as their primary concern. The goals of rapid and stable economic growth, high employment, and low inflation are usually the principal targets of macroeconomic policy. The dollar will likely be influenced by such policy actions, and its movement might well support achieving broader macroeconomic goals; but a particular level for the exchange rate is unlikely to be an explicit policy goal, and it would be misguided to describe such indirect exchange rate effects as evidence of an explicit “strong” or “weak” dollar policy. A major benefit of moving from fixed to floating exchange rates is that it frees the monetary authority from having to move interest rates to maintain the exchange rate at a fixed value, and allows it to focus monetary policy on domestic stabilization. Discretionary fiscal policy, to the extent that it can be used, will exert its effect on the exchange rate through the budget balance. Whether that balance is a surplus or deficit will be driven by forces largely unconcerned with the exchange rate.

If the dollar looked as if it were crashing and sharp increases of interest rates are threatened, then a quick policy response would be called for and would likely be forthcoming, most likely undertaken by the Fed. Such circumstances could place the Fed in a difficult spot. Stabilizing the exchange rate would dictate raising interest rates, but that would intensify the pressures faced by domestic interest-sensitive sectors. Insulating domestic economic activity would dictate lowering interest rates, but that would intensify the dollar’s depreciation. Most often, we can expect domestic stabilization goals to take precedent. This task would be easier if fiscal policy could also be used and easier still if other countries pursued complementary adjustment policies. (Remember, if the dollar is falling, other currencies must be rising, and that may not be desired by countries that are more dependent on exports.) A crashing dollar could be a difficult policy problem. But, as discussed above, such a crash seems to be a remote possibility.

Even if the dollar is unlikely to crash, some argue that the dollar is in need of a sizable downward correction. The motive might be to give relief to domestic producers of tradable goods or to stem the accumulation of foreign debt. How much

¹⁰(...continued)
aimed at the exchange rate.

¹¹ See the projection by Global Insight, U.S. Economic Outlook, June, 2004.

of a correction is open to debate, but it could certainly be well short of what is needed to balance the trade deficit. As we have seen, the dollar's path is largely dependent on decisions in international capital markets, made by lenders and borrowers alike. But policy can influence those decisions. One needs to be mindful, however, that capital markets themselves are capable of inducing an orderly adjustment and that such a market initiated adjustment may now be underway.

What is perhaps a more pertinent concern for economic policy are the factors moving the dollar, specifically smaller net inflows of foreign capital. The direction and magnitude of prospective movement of the dollar's exchange value will be substantially intertwined with the U.S. economy's use of sizable inflows of foreign financial capital to partially finance the economy's domestic investment spending. Healthy levels of investment spending undergird our long-term prosperity and we probably should not be indifferent to how well this important activity is proceeding. Because investment spending will likely rise with economic recovery, and because the level of domestic saving will likely continue to be smaller than what is needed to finance that level of investment, the demand for foreign capital will also grow. This will be a persistent force keeping the dollar relatively strong. "Relatively strong" is a somewhat ambiguous term: what is being suggested is that the dollar in this environment may hover well above the level consistent with balanced trade. Whether this points to some further depreciation from recent highs or a renewal of appreciation is difficult to judge.

For economic policy to prudently counter United States reliance on foreign capital and push and hold the dollar at a far lower value, would most likely require an increase in the rate of national saving. How we could achieve a larger flow of domestic saving is problematic. Because the government's most direct link to the level of national saving — the state of balance of the federal budget — is widely projected to be incurring deficits for the next several years, fiscal policy is assuming a posture that tends to appreciate the dollar. The path of monetary policy is certainly more flexible and the needs of a slowly recovering economy make it more likely that the Fed will follow a generally stimulative path in the near-term. This would perhaps be mildly supportive of depreciation of the dollar. But there is no strong reason to expect monetary policy to exert such strong downward pressure on the dollar that it would overcome even relatively moderate forces pushing to appreciate the dollar, such as rising investment spending, larger budget deficits, and economic weakness abroad.

Conclusion

A "weak" dollar is not necessarily bad and a "strong" dollar is not necessarily good. An accurate evaluation will depend on what has made the dollar weak or strong. The exchange rate is most often a symptom of movements of capital between countries. It is these flows, and the forces behind them, that are likely to shape our final opinion about what is good or bad economic performance.

A strong dollar that is the result of large capital inflows used to support budget deficits and consumption, as in the 1980s, may be viewed differently than a strong

dollar that is the result of capital inflows that finance a higher level of investment spending. The latter, because it will likely lead to a smaller decrement to our future living standard, seems superior. Similarly, a dollar that weakens in response to a shift to a higher level of domestic saving may be viewed differently than a weakening that is the result of investors moving away from a poorly run economy with few good investment opportunities. The former, because it will mean that more of the benefit of future growth will accrue to U.S. citizens, seems superior.

The recent weakening of the dollar is most likely a prudent response of investors to recent events in the U.S. economy, many of them likely transitory. And a slowing of U.S. debt accumulation may prove to be a positive development, particularly if it is caused by an increase in the rate of domestic saving. Yet how much weakening will occur is problematic. Under the most plausible scenario the U.S. economy will continue to use a sizable inflow of foreign capital to help finance domestic investment and will grow faster than other major economies. This would suggest that the dollar may not fall all that far.